PAYABLES FINANCE

What can we learn from the Abengoa and Carillion experiences?

2018

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International Trade and Forfaiting Association

Payables Finance: what can we learn from the Abengoa and Carillion experiences?

Pouya Jafari and Jana Kalousova, October 2018

Summary

Two notorious cases of payables finance arrangements almost managed to throw bad light on the practice as a whole, provoking a tough reaction by some rating agencies; Moody's were ready to start reclassifying these arrangements in the balance sheet from trade payables to bank debt. Such a generic measure would have had a vastly negative impact on the whole industry.

A closer look at both cases reveals that such extreme examples can be recognised by the presence of abnormal features. These should act as "red flags" in assessing the nature of a payables finance programme. A multi-factor and holistic analysis should therefore be carried out by rating agencies in making their adjustments. This has already been accepted in principle by one major rating agency following discussions with ITFA.

In making such an assessment, standard features of payables finance programmes should not be taken to raise red flags in and of themselves. Education and dialogue with industry players is therefore critical in arriving at the right conclusions and ITFA is committed in playing its part in this on-going process.

ITFA accepts that such an exercise can only be carried out with appropriate information. ITFA therefore recommends that auditors and accountancy standard bodies engage in discussions with all stakeholders to clarify methodology and a best practice approach to disclosure.

Background

Following the financial problems of Spanish company Abengoa S.A., Moody's published a report that argued Abengoa's reverse factoring – a type of supply chain financing (SCF) – had debt-like features that contributed to its pre-insolvency proceedings in 2015. Moreover, the report argued that Abengoa's case was not unique and that absent accounting disclosure requirements companies often choose not to disclose significant reverse factoring arrangements. The analytical effect of this, Moody's argued, is that companies appear less leveraged as their liabilities to the bank are classified as trade payables and not debt.[1] In order to produce comparable ratios across companies and industries, Moody's were about to reclassify such programmes as bank debt as part of their standard adjustments.

The Moody's report sparked an ongoing debate about the appropriate accounting treatment of SCF arrangements, the advantages and disadvantages of such programmes, and what the future holds for Buyers, Suppliers, and Finance Providers. Thanks to ITFA, the worst case scenario did not happen: at a roundtable with Moody's, ITFA managed to convince the ratings agency not to apply such changes in general, but rather on a case by case basis as long as certain debt-like features were clearly evident.

The discussion was accentuated by the liquidation of Carillion plc on 15 January 2018[2] and is certainly not over. To the benefit of ITFA's members, the following paper provides a high-level overview of the considerations required when assessing payables arrangements and calls for more transparency in financials provided by companies.

Payables Finance: definitions and key features

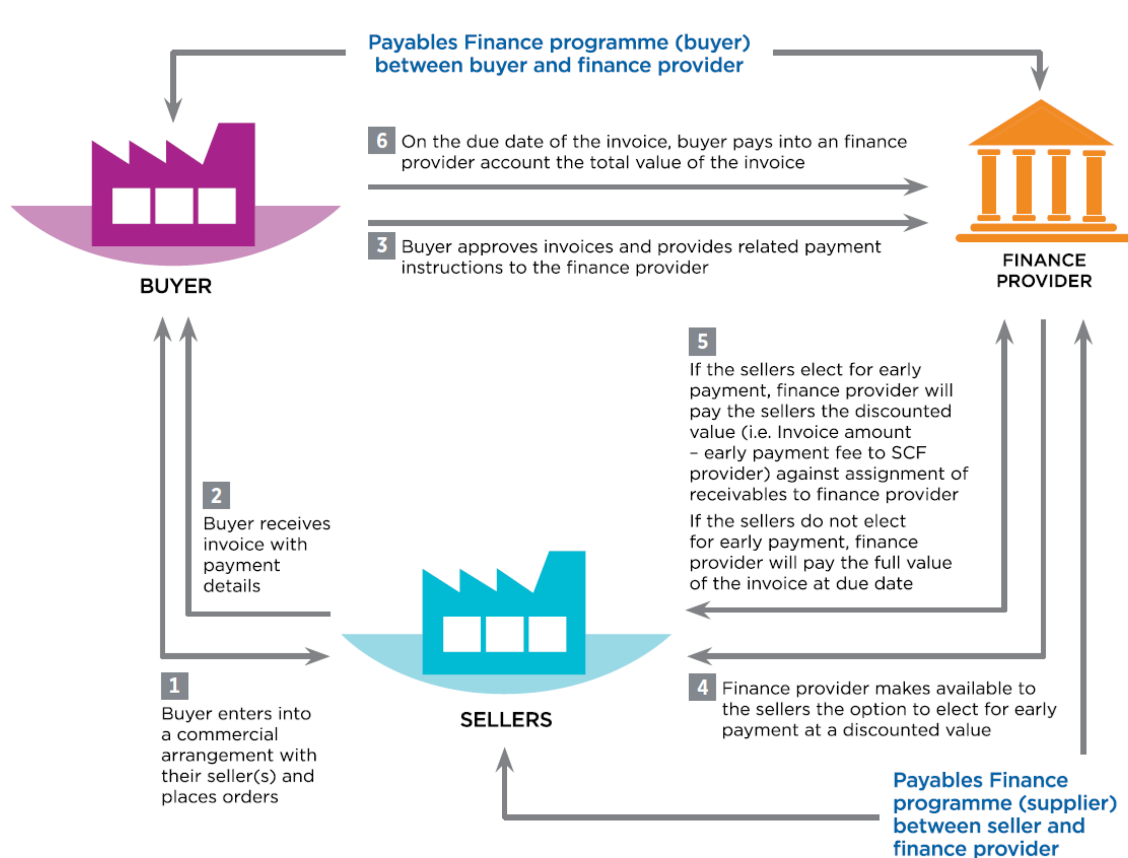
This section draws on the "Standard Definitions for Techniques of Supply Chain Finance" published in 2016 and co-authored by ITFA together with ICC, BAFT, EBA and FCI.[3]

Supply Chain Finance (SCF) refers to the set of solutions available for financing specific goods and/or products as they move from origin to destination along the supply chain. The term is also used to define the financial relationship linking the Buyer and the Supplier together in terms of payables and receivables.

Payables Finance is one specific technique within this universe, "provided through a Buyer-led programme within which sellers in the Buyer's supply chain are able to access finance by means of Receivables Purchase. The technique provides a seller of goods or services with the option of receiving the discounted value of receivables (represented by outstanding invoices) prior to their actual due date and typically at a financing cost aligned with the credit risk of the Buyer. The payable continues to be owed by the Buyer until its due date." Other terms used to refer to this specific technique include Approved Payables Finance, Reverse Factoring, Confirming, Confirmed Payables, Supplier Payments, Vendor Pre-Pay, Trade Payables Management, Buyer-Led Supply Chain Finance, Supplier Finance, or just Supply Chain Finance (the latter two when applied as an individual 'technique' rather than a holistic category).

The key feature of a payables arrangement is that it is **Buyer-centric**, with the Buyer acting as the programme arranger. That means the Finance Provider relies on the credit-worthiness of the typically large-sized Buyer, which gives an irrevocable and unconditional approval to pay the selected invoices. The Finance Provider then extends financing "without recourse" to Suppliers.

The technique was originally implemented by large aerospace and manufacturing companies seeking to extend their payment terms to their Suppliers in order to improve their own balance sheets. Smaller Suppliers would see their working capital cycle extend, creating a need for additional financing. Under a payables finance arrangement, Suppliers are given the opportunity to receive payments (minus fees) before their due date and at a cost based on the credit risk of the Buyer, i.e. lower than obtained on their own. The Buyer pays the total value of the invoice on maturity.



Source: Global Supply Chain Forum, "Standard Definitions for Techniques of Supply Chain Finance", 2016

Payables finance brings clear advantages to all the participants

All the parties in payables finance arrangements – a Buyer, Suppliers and Finance Provider(s) (plus, sometimes also an IT platform provider) – have significant incentives to participate, which outweigh potential disadvantages. The main advantages and disadvantages are outlined below:

Buyer's perspective

+ Buyer extends its payment terms and thereby **improves its working capital**
+ Using a source of financing which is in substance trade payables, i.e. **not treated as debt** for balance sheet purposes (which would impact leverage position)
+ Buyer maintains the relationship and payment terms to Suppliers, resulting in a **greater supply chain stability**
+ Thanks to the interest cost benefits Suppliers achieve from financing based on the Buyer's creditworthiness, Suppliers are ready to offer more favourable terms and conditions to the Buyer
+ Buyer outsources payables management operations to the Finance Provider
+ The platform allows the Buyer to have visibility from a single location over the payment process of several subsidiaries across a region
+ Buyer may improve its public image, following governmental initiatives to pay smaller Suppliers earlier[4] [5]
− Any dilutions between the Buyer and Sellers are to be resolved outside of the payables structure, i.e. the Buyer gave the unconditional and irrevocable approval to pay which must be fulfilled
− Payables finance consumes Buyer's credit lines with the Finance Provider

Suppliers' perspective

+ Suppliers can **optimise their working capital at costs based on a higher credit rating** of a strong Buyer
+ … **consuming the credit lines of the Buyer**, not the Supplier
+ Suppliers can better forecast the working capital and cash flow, having the flexible option to not discount and hold the receivable until maturity
− Even if the Supplier is supposed to make an independent decision on whether or not to utilise the programme, the prolonged payment terms enforced by a strong Buyer may be significantly longer than the market standard, i.e. forcing Suppliers to utilise the programme

Finance Provider's perspective

+ A financial institution provides financing based on the creditworthiness of a **known debtor** (Buyer), supported by its unconditional and irrevocable commitment to pay the confirmed invoices
+ Finance Provider is exposed to limited risk due to the usually **uncommitted basis** of the facility
+ Finance Provider earns a **margin on the high quality risk** (i.e. transaction-based short term risk associated with the day-to-day activity of clients)
+ There is no dilution risk as any dilutions are sorted out outside the facility (as above)

Payables finance proved to be a useful tool after the liquidity crisis in 2008-9, when extended payment terms became prevalent in the whole market, and in turn Suppliers sought to discount these extended terms in order to accelerate their cash flows. Consequently, there was a wider drive to push banks to support their corporate clients, and for large Buyers to support their (often smaller) Suppliers.[6]

Looking at industry sectors, payables finance is most common in industries where Buyers' ratings are much higher than their Suppliers', such as **automotive, retail and industrials**. It is also common in **construction**, where ratings are usually lower and companies are looking for additional sources of liquidity, without increasing reported financial debt.[7]

According to Moody's[8], a **further growth of payables finance can be expected** in light of various government initiatives to help Suppliers get paid on time (e.g. EU's Late Payment Directive, US' SupplierPay). As a result, many Buyers will require additional working capital to meet these government initiatives.

Black sheep: Abengoa and Carillion

Abengoa S.A., a Spanish environment and energy group, announced pre-insolvency proceedings in November 2015. Financial analysis performed by Moody's[9] brought to light some noteworthy issues, which were not clearly visible at first sight when looking at the basic performance indicators and which are not typical for payables finance arrangements:

- EUR 1.2 bn, a considerable part (43%) of Abengoa's **cash and cash equivalents, was related to deposits for confirming debt** (i.e. payables finance)
- **unusually long payment terms** (219 days in 2014)
- **high related financial expenses** of EUR 85MM in 2014 for the "outsourcing of payables"

View on Abengoa's financials:

Reported financial leverage without considering confirming (reverse factoring)

	2013	2014
Group EBITDA	1,267	1,408
Consolidated Gross Debt	11,852	10,162
Current financial investments	926	1,049
Cash and Cash equivalents	2,952	1,811
o/w deposit and cash linked to confirming without recourse	1,337	1,226
as % of cash, cash equivalents and current financial investments	34%	43%
as % of confirming without recourse liabilities	56%	54%
Total net debt	7,974	7,303
Consolidated gross leverage	9.4	7.2
Consolidated net leverage	6.3	5.2

Figures in € million, based on Abengoa's definitions, excluding Moody's adjustments
Source: Abengoa annual report, Moody's calculations

Analysis of Abengoa's trade payables

	2013	2014
Trade payables for goods and services	4,829	5,096
o/w confirming without recourse	2,377	2,250
as % of trade payables	49%	44%
Payables related to capex and others	-635	-1,425
Payables related to expenses	4,194	3,671
ex VAT (21%)	-728	-637
Payables related to expenses ex VAT	3,466	3,034
Raw materials and consumables used	4,470	4,083
Other operating expenses	1,201	977
Cost of goods sold and other operating expenses	5,671	5,060
Trade Payable Days	223	219

Source: Source: Abengoa annual report 2014, Moody's Investors Service

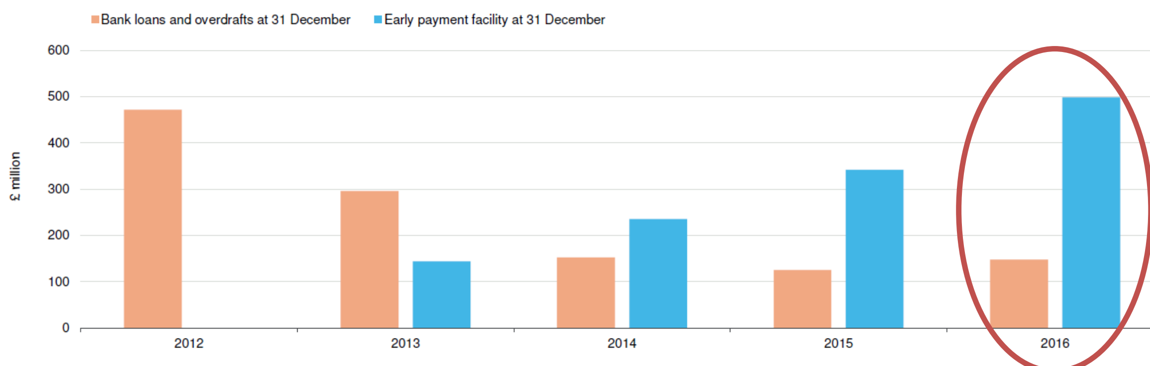
Source: Moody's, "Abengoa S.A: Reverse Factoring Has Debt-Like Features", 15 December 2015

Carillion plc, one of the UK's leading support services and construction companies, entered into compulsory liquidation on 15 January 2018. Similar to Abengoa, the presented net debt-to-EBITDA ratio (below 1.0x) did not make it evident that the company might be a bankruptcy candidate. A closer look at the financials by Moody's[10] revealed the following features, again unusual for the payables finance facilities:

- **large size of the payables finance programme** (GBP 498MM in 2016) **compared to the liabilities** to banks (approx. GBP 148MM in 2016)
- key source of cash inflow (98%) was in fact bridging finance supplied by Carillion's banks under the payables finance arrangement
- significant **costs related to the payables finance borne by Carillion**
- **payment terms** to Suppliers extended within the payables finance programme were **substantially longer than the industry standard** (120 days). This disadvantage to Suppliers was compensated by paying them on the original terms or even 20 days earlier, at no cost to Suppliers.

View on Carillion's financials:

Carillion's early payment facility expanded considerably after reverse factoring commenced in 2013



Sources: company annual reports and the 2016 results presentation.

Source: Moody's, "Carillion's collapse highlights shortcomings in the accounting for reverse factoring", 13 March 201Taking these two extreme cases into account, Moody's argued that both net and gross leverage, as calculated by both companies following the current accounting standards, were underestimated and did not properly illustrate the indebtedness of the companies. **As a result, Moody's suggested several adjustments** (e.g. not considering the pledged cash deposits and re-classifying trade payables as part of the gross debt), **leading to an overall increase in net and gross leverage** (in the case of Abengoa: net leverage 1.3x-1.5x higher, gross leverage 0.4x-0.5x higher[11]).

Accounting treatment considerations: there is no "one-size-fits-all"

However precise the financial analysis may strive to be, there are several considerations that make it hard to measure the exact extent of the payables finance of the company. Firstly, accounting standards do not always require disclosure of payables finance activity. Secondly, there is a lack of consistent terminology across regions (e.g. the term "trade payables" may be understood differently in terms of underlying obligation).

Existing **accounting standards accept that companies classify payables finance as trade payables** (and not as debt), **as long as there are no changes to the economic substance of the transaction**. So the key question is: did the payables finance programme lead to substantial changes to the contractual terms and conditions of the trade debt between Buyer and Seller, such as the due date, amount, or interest rates?

As a matter of fact, **companies do not interpret these rules uniformly**; not even across the same industry, as demonstrated by an analysis performed by Moody's[12] of three EMEA telecommunication companies (Deutsche Telecom AG, Orange and Telefonica S.A.).

Some basic indicators[13] may help to assess the change in the economic substance, possibly resulting in the re-classification of trade payables as debt (see the Annex for further more detailed indicators), such as:

1. Payments terms are extended beyond industry norms (indicating that the term extension exists solely because of third party financing)
2. The Buyer assumes the financial costs of the discounting of receivables
3. There is new security – the Buyer's parent guarantee or cash collateral – to the Finance Provider on top of what the Supplier would have had
4. Relative large size of the programme compared to other liabilities to banks
5. A receivable has been discounted and the Buyer repays its debt beyond the maturity agreed with the Supplier
6. The payables finance facility is committed

Of course, each of the above-mentioned criteria is unique to every arrangement and requires the use of judgement by companies working with their auditor. There is no "one-size-fits-all" approach.

Watch out for red flags indicating extreme cases

Abengoa and Carillion are illustrative examples of cases which arguably should have been re-classified as bank debt, but which do not in any case represent typical payables finance arrangements.

The question is: "Does applying the above mentioned criteria to Abengoa and Carillion help in recognising non-standard payables finance arrangements?"

Criteria	Abengoa	Carillion
1. Payment terms far beyond industry norms	✓	✓
2. Buyer assuming costs	✓	✓
3. Additional collateral	✓	-
4. Relatively large size of the program	(✓)	✓
5. Buyer re-paying beyond maturity	-	-
6. The facility is committed	-	-

As shown in the chart, both Abengoa and Carillion meet at least three of the re-classification criteria, and, as such, an argument can be made that the relevant programmes should have been reclassified as bank debt. ITFA is concerned with the apparent negative connotations that these two cases may give to the legitimacy of payables finance. **Extreme exceptions should not make bad law.**

The multiple benefits of payables finance are detailed above and in the annex, and their crucial importance and availability to buyers and suppliers alike **have become an integral part of the financing ecosystem for trade debt**.

ITFA: a discussion is needed to clarify disclosure of appropriate information

Rating agencies have focused much of their attention on one metric: the increase in days payable by buyers. Whilst this has undoubtedly occurred, this is as a result of a number of factors including lengthening and deeper global supply chains and is a market phenomenon. The expectation of payables finance has become an embedded factor in treasury toolkits and, for many corporates, is now an inseparable element of the overall calculus that they will carry out when fixing pricing terms. ITFA therefore recommends that, in relation to this important metric, rating agencies and auditors should only take into account material deviations from industry payment norms which can only be explained because they are supported by other abnormal features of such programmes. **The presence of abnormal features such as those set out in this paper should act as "red flags" in assessing the nature of a payables finance programme**. **A multi-factor and holistic analysis should therefore be carried out by rating agencies in making their adjustments.** This has already been accepted in principle by one major rating agency following discussions with ITFA.

In making such an assessment, standard features of payables finance programmes should not be taken to raise red flags in and of themselves. For example, it is inevitable that the final recipient of the payment will become a bank and will no longer be the original supplier. It is also very common for buyers to provide payment undertakings which are, in effect, no different to promissory notes or accepted bills once prevalent in trade finance and which still play an important part in many jurisdictions. **Education and dialogue with industry**

players are therefore critical in arriving at the right conclusions and ITFA is committed in playing its part in this on-going process.

ITFA accepts that such an exercise can only be carried out with appropriate information. **ITFA therefore recommends that auditors and accountancy standards bodies engage in discussions with all stakeholders to clarify methodology and a best practice approach to disclosure. ITFA will facilitate that discussion which must involve banks and other financial institutions.**

Annex

<u>There are good arguments on both sides of the table</u>

Payables finance does have some debt-like characteristics, as raised by Moody's[14] and PwC[15], namely:

1. A **bank provides funds** which enable Buyers to extend payment times and sellers to be paid sooner
2. The bank's payment to the Supplier transforms trade payables into liabilities **owed by the Buyer to a bank**
3. Bank credit lines for payables finance are usually uncommitted, so that they can be withdrawn at short notice and, **if this tool became a permanent feature of a company's financing**, negatively affect Buyer's short-term liquidity
4. Banks may require **collateral** (cash or cash equivalents or short-term investments) from the Buyer depending on its credit quality, treating a payables finance programme like other loans

On the other hand, the following arguments support characterisation as a trade payable:

1. Key criteria according to the accounting rules: **unchanged economic substance** of the trade relationship between Buyer and Supplier
2. Despite the involvement of a Finance Provider, **the obligation for a Buyer to pay remains** unchanged
3. **Payment terms remain typical** for the specific company and industry
4. **Supplier keeps its autonomy** in the relationship
5. **Financial costs are born by Suppliers**
6. If the uncommitted funding were withdrawn, it would be the Supplier that would suffer the most, not receiving the payment earlier. It would mean no change for the Buyer that pays in any case on the maturity.

<u>Additional criteria indicating that trade payables under the payables finance programme may have debt-like features</u>

According to PwC[16], the presence of certain terms may also suggest that the obligation is in substance debt:

- An incremental increase in the price of the goods to compensate vendors who provide extended payment terms
- The original liability being extinguished
- Interest accruing on the balance prior to the due date (although penalties for non-payment may be imposed after that)
- The financial institution having the right to draw on the company's other accounts without its permission if the designated payment account has insufficient funds, if not part of the company's normal banking arrangements
- Altering the trade payable's seniority in the company's capital structure
- Requiring the company to post collateral on the trade payable
- Default on invoice payment under the arrangement triggering a cross-default (other than a general debt obligation cross-default)

As well as other criteria:

- Significant involvement of the Buyer in the negotiations of terms between the Supplier and the bank
- The Buyer does not retain its right to pay Supplier directly

- The programme is mandatory for Suppliers (they do not have the freedom to discount when it suits their cash flow or wait and be paid at maturity)
- The Finance Provider receives new rights that the Supplier did not have before
- Variable fees based on vendor participation
- Obligations are no longer consistent with UCC-compliant trade payables

One area of focus is to ask if the terms of the debt have been changed on a transfer to the Finance Provider. Appendix B paragraph B3.3.6 of IFRS 9 (referring back to paragraph 3.3.2. of IFRS 9) provides a prescribed methodology for a quantitative assessment. This paragraph states that "for the purposes of paragraph 3.3.2, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability".

[1] Moody's, "Abengoa S.A: Reverse Factoring Has Debt-Like Features", 15 December 2015
[2] Moody's, "Carillion's collapse highlights shortcomings in the accounting for reverse factoring", 13 March 2018
[3] A copy of this can be found on the ITFA website and on the website of the Global Supply Chain Finance Forum of which ITFA is a member: http://supplychainfinanceforum.org/
[4] Department for Business Innovation & Skills, "Strengthening UK Supply Chains: Good practice from industry and government", January 2014
[5] The White House, Office of the Press Secretary, "President Obama Announces New Partnership with the Private Sector to Strengthen America's Small Business; Renews the Federal Government's QuickPay Initiative", 11 July 2014
[6] ITFA, "Moody's Roundtable Discussion with ITFA", 7 December 2016
[7] Moody's, "Abengoa S.A: Reverse Factoring Has Debt-Like Features", 15 December 2015
[8] Moody's, "Abengoa S.A: Reverse Factoring Has Debt-Like Features", 15 December 2015
[9] Moody's, "Abengoa S.A: Reverse Factoring Has Debt-Like Features", 15 December 2015
[10] Moody's, "Carillion's collapse highlights shortcomings in the accounting for reverse factoring", 13 March 2018
[11] Moody's, "Abengoa S.A: Reverse Factoring Has Debt-Like Features", 15 December 2015
[12] Moody's, "Keep an eye on trade payables when evaluating leverage", 28 November 2017
[13] The 6 criteria were selected out of many mentioned in the sources above and a report from PwC, "Structured payables – could they be debt?" revised November 2016. The selected 6 features were mentioned by most of the reports' authors and thereby are considered as most relevant.
[14] Moody's, "Abengoa S.A: Reverse Factoring Has Debt-Like Features", 15 December 2015 and Moody's, "Carillion's collapse highlights shortcomings in the accounting for reverse factoring", 13 March 2018
[15] PwC, "Structured payables – could they be debt?", revised November 2016
[16] PwC, "Structured payables – could they be debt?", revised November 2016